NEW ZEALAND LOCAL GOVERNMENT FUNDING AGENCY
TE PŪTEA KĀWANATANGA Ā-ROHE

21 May 2020

Refinancing Alternatives for Councils with May 2021 loans

Background:

After a volatile February-March period we have seen stability return to New Zealand debt markets with a significant fall in yields tightening in LGFA borrowing spreads. Both outright yields and borrowing spreads are either at or very close to historic lows as a result of the Reserve Bank of New Zealand buying LGFA bonds as part of its Large-Scale Asset Purchase programme ("LSAP")[1]. Under the LSAP the Reserve Bank can buy up to 30% of outstanding LGFA bonds on issue.

We are a year away from the maturity of the May 2021 LGFA bond and associated council on-lending. Forty-six councils have borrowed $1.351 billion from LGFA into the 15th May 2021 maturity date and LGFA has issued $1.45 billion of bonds to finance this on-lending. In addition, LGFA also has an additional $337 million of longer-term lending to councils which is due to mature between now and the 15th May 2021.

The May 2021 month will be a busy period for New Zealand capital markets with a number of government and corporate bond maturities. The government's May 2021 maturity is $11.3 billion. There will be significant domestic capital markets activity by both issuers and investors during the June 2021 quarter.

We expect that most councils will look to either partially or totally refinance their borrowings ahead of 15th May 2021 as:

- Most councils don't have surplus funds to repay the borrowing.
- Some councils have Treasury Policy restrictions such as the need to have liquidity cover in place for a certain period of time ahead of an upcoming maturity.
- Our experience with the March 2019 and April 2020 maturities was that all but a few of the smaller councils refinanced ahead of the final maturity date.

LGFA will manage its refinancing risk by:

- Holding nine bond tenders between now and May 2021. Councils can undertake borrowing from LGFA at any time during the year or can borrow on the tender dates.
- Issuing longer dated LGFA bonds in order to increase the size of LGFA's liquid asset portfolio. This will enable LGFA to repay investors $1.45 billion on the 15th May 2021.

[1] Charts of yield and spread movements are in the Appendix

<u>Refinancing Alternatives for Councils:</u>

There are several alternatives for councils to consider as they approach the 15th May 2021 maturity date of their loans

1. Fully or partially repay your loans. ("Repayment at Maturity") Given that councils are borrowing against long dated assets this is an unlikely scenario. Furthermore, LGFA provides the cheapest source of short and long term borrowing to council members so we would suggest that councils are not likely to refinance using more expensive financing alternatives.

2. Do nothing and refinance your existing May 2021 loans via the May 2021 LGFA bond tender. ("Refinance at Maturity") The advantage of this is that you don't have to do anything until maturity date and there is no impact on your cash flows, financial statements or gross debt levels. The disadvantage is the lack of certainty over the refinancing cost. As we have seen this year, financial markets can be volatile which can create some uncertainty regarding the ability to borrow and the cost of debt. Councils might have to hold liquid assets or standby facilities to meet Treasury Policy requirements.

3. Borrow into a new longer maturity date ahead of 15th May 2021 and repay your existing May 2021 loans. ("Borrow and Repay") We can provide indicative new borrowing margins at any time and margins are also published on a weekly basis each Wednesday. We can also calculate the cost to repay your May 2021 loans at any time. We would expect there to be a small cost to repay the loans as borrowing margins have narrowed and yields have declined over recent years since the loans were first taken out. However, the lower margins and lower yields will mean that it is cheaper to borrow / refinance for longer terms. The advantage of this approach is that it has no impact on your gross debt levels and it extends the duration of your debt portfolio. It provides certainty over your borrowing margin and refinancing. You may not have to hold liquid assets or standby facilities to meet Treasury Policy requirements. The disadvantage is that there will be an upfront cost to repaying your existing May 2021 loan that will be taken into the current year financial statements.

4. Borrow into a new longer maturity date ahead of 15 May 2021 and repay existing May 2021 loans. Blend any loss into the new loan margin on the longer loan maturity. ("Blend and Extend") LGFA will allow councils to blend any marked to market loss on the May 2021 loan into the margin on the new borrowing. This will mean a slightly higher borrowing margin for the new longer dated maturity. The amount of additional margin will be a function of the margin on the existing 2021 borrowings and the term of new borrowing. LGFA does not charge any additional cost for this type of transaction. On the blend and extend transactions that we have undertaken so far, the additional margin has been between 2 bps and 10 bps. The advantage of this approach is that it has no impact on your gross debt levels and it extends the duration of your debt portfolio. It provides certainty over your borrowing margin and

refinancing. You may not have to hold liquid assets or standby facilities to meet Treasury Policy requirements. The disadvantage is that there will be a slightly higher borrowing margin over the term of the new loan.

5. Borrow into a new longer maturity date and place the funds on deposit with a bank. ("Borrow and Invest") Councils can borrow either in between tenders or via one of the LGFA bond tenders to be held in the 2020/21 calendar year. The proceeds are placed on a term deposit with a bank to mature 15th May 2021. There could be a positive financial outcome for the council borrower as term deposit rates are above the council floating rate borrowing margins from LGFA. Approximate deposit rates from the major banks are currently:

Term	Deposit Rate	Approximate Margin to BKBM
3 months	**0.95%**	**+0.75%**
6 months	**1.45%**	**+1.20%**
9 months	**1.45%**	**+1.20%**
12 months	**1.45%**	**+1.20%**

The above term deposit rates are for interest paid at maturity so a direct comparison is not perfect and there will be some cash flow mismatches to manage as a council is making interest payments on a quarterly basis. The advantage of this approach is that it is likely to have a positive financial impact from the net interest margin earned as the cost of borrowing from LGFA may be lower than the return from your Term Deposit[2]. This alternative also extends the duration of your debt portfolio and provides certainty over your borrowing margin and refinancing. You may not have to hold liquid assets or standby facilities to meet Treasury Policy requirements as the Term Deposits would be treated as assets. The disadvantage is that your gross debt level will increase until 15th May 2021 and you will incur credit risk on the bank (or banks) with your term deposit investments. Your net debt levels will however be unchanged.

6. Borrow into a new longer maturity date via a tender (or on an intra tender basis) prior to May 2021 but with settlement on the 15th May 2021. ("Forward Start Refinancing") Under this alternative you can borrow at any of the LGFA tenders held in the 2020/21 financial year (or intra tender) but delay the settlement of the loan until 15th May 2021. You will lock in the borrowing margin and this will also provide certainty as to your refinancing. LGFA does not charge any additional cost for doing this over and above its cost of hedging. We estimate the additional cost to be 2 bps to 5 bps depending upon the term of borrowing and how close the chosen tender is to 15th May 2021. The advantage of this approach is that it extends the duration of your debt portfolio and provides certainty over your borrowing margin and refinancing. There is no financial impact. You may not have to hold liquid assets or standby facilities to meet Treasury Policy requirements as you have refinancing in place. The

[2] See the appendix for current LGFA lending rates and margins to BKBM for terms out to 2033

disadvantage is that you may have to disclose in your financial statements the commitment to borrow on 15th May 2021.

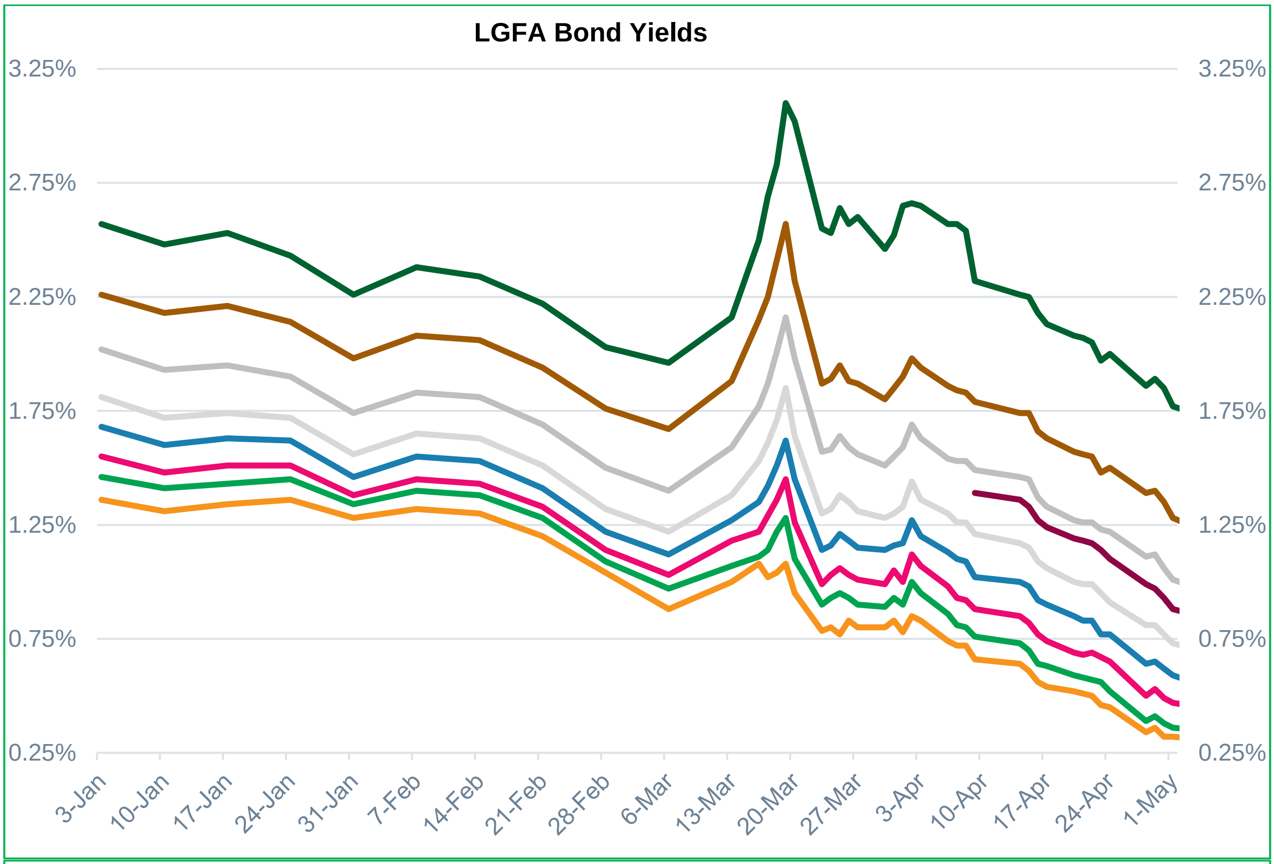
7. Repay the 15th May 2021 loan when due by borrowing short term (less than twelve months). Refinance the short-term loan with longer dated funding later in 2021. ("Short Term Refinancing") Under this alternative you can borrow for a term out to 12 months. You can then refinance the short-term loan with a longer-term loan in 2021 or partially repay from cash flow. The advantage of this approach is that you can defer your long-term borrowing decision until 2021 or 2022 so it does provide some flexibility. This alternative could be cheaper as short term borrowing margins are lower than long term borrowing. The disadvantages are that you don't have the certainty of the long-term borrowing cost and you are not extending the duration of your debt portfolio. You may also have to hold additional standby facilities to meet Treasury Policy requirements.

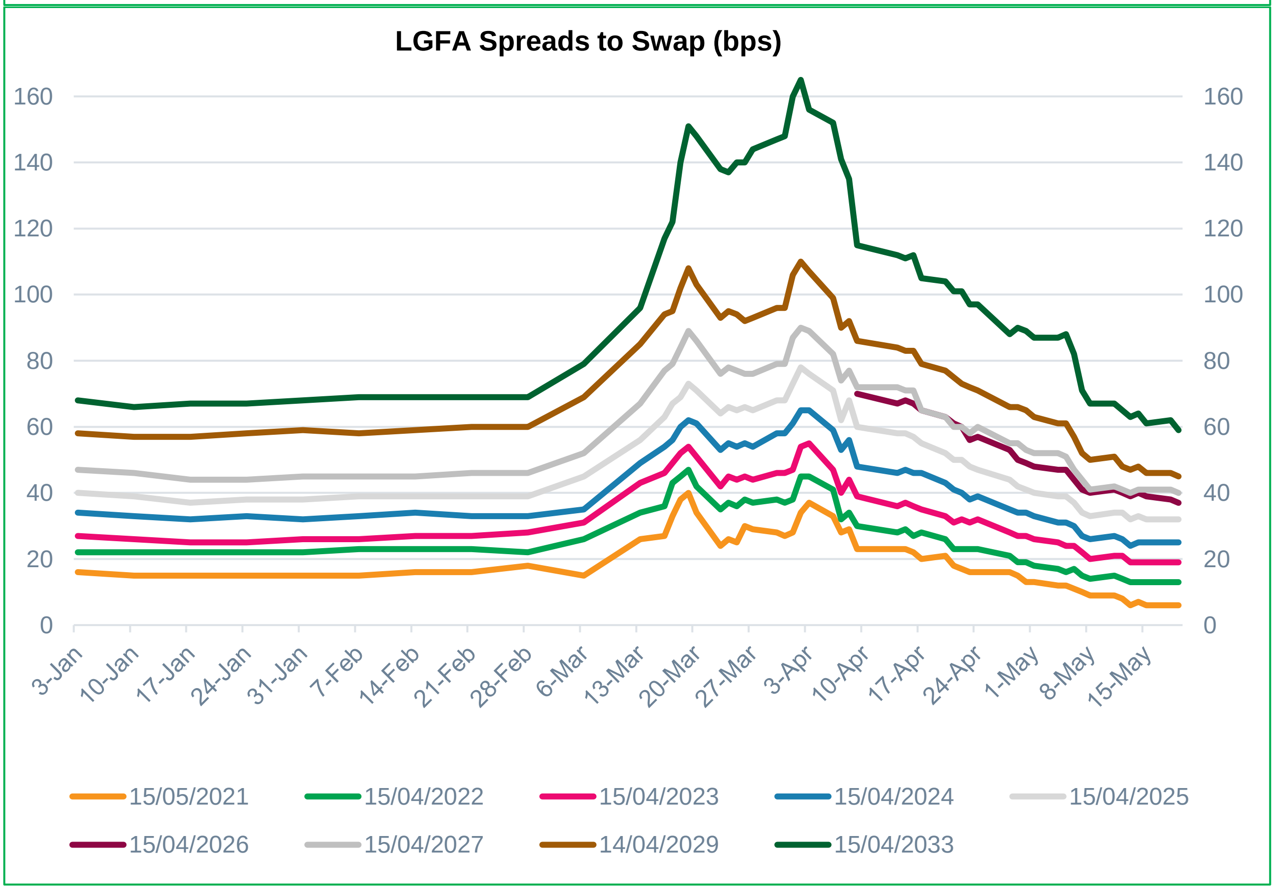
Conclusion:

LGFA believes that councils should not leave their refinancing decision until the maturity of their loans on 15th May 2021. There are several refinancing alternatives that can be considered and depending upon individual council circumstances some will be more suitable than others. We suggest that you consult your treasury advisor as to which alternative is best for your council.

LGFA is happy to assist with discussing in more detail and providing pricing for these alternatives so please contact either Andrew Michl or Mark Butcher.

Appendix   LGFA Bond Yields and LGFA Bond Spread to Swap





Appendix LGFA Fixed Rate Lending Yields and Floating Rate Lending Spreads for Councils as at 20 May 2020

Fixed Rate Long Term Borrowing	Base Yield	Borrowing Yield AA rated Councils	Borrowing Yield AA- rated Councils	Borrowing Yield A+ rated Councils	Borrowing Yield Unrated Guarantors	Borrowing Yield Non Guarantors
May-21	0.30%	0.50%	0.55%	0.60%	0.70%	0.80%
Apr-22	0.31%	0.51%	0.56%	0.61%	0.71%	0.81%
Apr-23	0.38%	0.58%	0.63%	0.68%	0.78%	0.88%
Apr-24	0.46%	0.66%	0.71%	0.76%	0.86%	0.96%
Apr-25	0.59%	0.79%	0.84%	0.89%	0.99%	1.09%
Apr-26	0.72%	0.92%	0.97%	1.02%	1.12%	1.22%
Apr-27	0.82%	1.02%	1.07%	1.12%	1.22%	1.32%
Apr-29	1.03%	1.23%	1.28%	1.33%	1.43%	1.53%
Apr-33	1.43%	1.63%	1.68%	1.73%	1.83%	1.93%

Floating Rate Long Term Borrowing	Base Margin	Borrowing Margin AA rated Councils	Borrowing Margin AA- rated Councils	Borrowing Margin A+ rated Councils	Borrowing Margin Unrated Guarantors	Borrowing Margin Non Guarantors
May-21	12 bps	32 bps	37 bps	42 bps	52 bps	62 bps
Apr-22	17 bps	37 bps	42 bps	47 bps	57 bps	67 bps
Apr-23	28 bps	48 bps	53 bps	58 bps	68 bps	78 bps
Apr-24	31 bps	51 bps	56 bps	61 bps	71 bps	81 bps
Apr-25	40 bps	60 bps	65 bps	70 bps	80 bps	90 bps
Apr-26	43 bps	63 bps	68 bps	73 bps	83 bps	93 bps
Apr-27	53 bps	73 bps	78 bps	83 bps	93 bps	103 bps
Apr-29	55 bps	75 bps	80 bps	85 bps	95 bps	105 bps
Apr-33	81 bps	101 bps	106 bps	111 bps	121 bps	131 bps